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Iran-Iraq: A Comparison of Two War-Wearied Economies

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An Intelligence Assessment

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Iran-Iraq: A Comparison of Two War-Weary Economies

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An Intelligence Assessment

This paper was prepared by [redacted]
[redacted] Office of Near Eastern and South
Asian Analysis. Comments and queries are
welcome and may be directed to the Chief, Persian
Gulf Division, NESA [redacted]

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**Iran-Iraq: A Comparison of
Two War-Weary Economies**

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Key Judgments

*Information available
as of 10 November 1988
was used in this report.*

Iraq is emerging from eight years of war in a stronger economic position than Iran. Baghdad has accumulated a large foreign debt but has maintained and even developed many sectors of its civilian economy during these years. Iran's opposition to foreign borrowing forced it to pay for the war by slashing civilian spending, causing widespread deterioration throughout its economic infrastructure, including its vital oil sector. This deterioration—combined with Iran's much larger and rapidly growing population—will probably inhibit Iran's economic growth more than Iraq's debt servicing will dim Baghdad's economic prospects.

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Most critical, Iraq has a better outlook for oil production and exports than does Iran. Iraq's proved oil reserves are second only to Saudi Arabia's, and most industry analysts believe much more oil exists in unexplored areas of western Iraq. Since suffering initial production and export losses early in the war, Baghdad has gradually increased its oil exports and revenues by building new oil pipelines and maintaining existing facilities. Assuming oil prices in the \$13-to-\$16-per-barrel range and exports of about 3.3 million barrels per day (b/d), Iraq could earn \$15-20 billion in oil revenues annually by 1990—the highest level since 1980.

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Iraq's nonoil infrastructure is also in better shape than is Iran's. Because Baghdad generally invested enough resources to meet the growing demand for public services, Iraq can probably concentrate new spending on growth-oriented economic development more quickly than Iran, which initially will have to concentrate much more on reconstruction.

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Servicing its \$40 billion non-Arab military and civilian debt will probably be Baghdad's major challenge. Payments will be high, and Baghdad will seek reschedulings. A failure to continue servicing its debt would adversely affect Iraq's ability to secure new loans needed to fund reconstruction and pursue economic development.

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In contrast to Iraq, widespread deterioration has occurred throughout Iran's economy, including its oil sector. Iran's current oil production capacity of roughly 3 million b/d is about half what it was 10 years ago. The Khomeini regime's policy to reduce oil development, falling oil prices, the war's resource demands, and Iran's refusal to borrow abroad have resulted in considerable neglect of oil-sector maintenance and development.

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Rapid population growth has greatly increased the stress on Iran's deteriorated infrastructure. The country's electrical power generation, and its transportation, industrial, and health sectors have fallen far behind the increased demand for services and jobs as its population grew from about 37 million in 1978 to 52 million by midyear 1988. Iran will have difficulty maintaining depressed living standards, let alone achieve higher ones. Iran's chances of improving its economic situation are further hampered by a shortage of skilled labor and by political factionalism over economic issues—especially regarding the level of foreign involvement in reconstruction, which is likely to intensify as reconstruction efforts progress. [REDACTED]

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Huge investment spending would be required to reverse Iran's economic decline, but Tehran's prospects for securing the necessary hard currency are dim. Although the regime is likely to soften its opposition to foreign credit, acceptance of large, multibillion dollar loans appears unlikely because of a political loathing to abandon openly Iran's commitment to independence. Furthermore, many lenders are unwilling to extend large loans to Tehran because of concerns about Iran's political stability. [REDACTED]

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Both Iran and Iraq offer significant commercial opportunities for Western firms—particularly as reconstruction begins—but prospects for increased US economic ties to Iraq are greater than to Iran during the near term. Iraq has expressed strong interest in expanding trade ties to the United States beyond current US agricultural sales and has pressed for more US Government credit guarantees to facilitate deals. Iran's larger economy and greater need for development offer significant opportunities for foreign firms, but US commercial opportunities in Iran will be limited by funding constraints and Washington's poor political relations with Tehran. [REDACTED]

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Iran-Iraq: A Comparison of Two War-Weary Economies

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Why Compare These Economies?

The cease-fire in the Iran-Iraq war on 20 August 1988 is the first step toward a resumption of normal economic activity and growth and development by these two countries. As major world oil producers, Iran and Iraq have the potential to be large markets for US and other OECD exports and to wield a significant degree of economic power relative to most other OPEC and Third World countries.

The increase in Iraq's proved oil reserves this year to 100 billion barrels—second in the world only to Saudi Arabia—makes Iraq's economic potential particularly significant. We believe that this oil edge counterbalances Iran's important geopolitical position and challenges the longstanding assumption that, of the two, Iran possesses the greater strategic value to US and Western interests.

An end to the war provides opportunities for US and Western countries and firms to participate in postwar reconstruction projects. Rebuilding these economies is likely to cost tens of billions of dollars and will require a wide range of foreign goods, services, and financial assistance.

Which Economy Had More Difficulty Paying for the War?

Iran encountered more difficulty financing the war than did *Iraq*—despite higher oil revenues in 1982-85 and lower expenditures for military hardware—because it relied almost exclusively on its own resources.¹ Unwilling to borrow from abroad because of Islamic precepts against paying interest, its desire for independence, and a scarcity of allies from which to seek assistance, Tehran had to rely almost exclusively on foreign exchange reserves and curtailing civilian imports. Foreign assets fell from about \$19 billion in 1980 to \$5.5 billion last year, of which we estimate only \$1.5 billion are liquid reserves. Civilian

imports in 1986—about \$8 billion—were nearly 35 percent less than in 1980 despite a near 20-percent increase in population during the time period. Tehran solicited private “donations”—often involuntary—from its populace and enacted other measures to generate revenues, such as increasing fees for exit visas.

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Unlike Iran, *Iraq* sought outside assistance to help fund its war effort. Baghdad borrowed heavily from abroad and secured substantial financial aid from its Arab allies, which allowed it to pay for military and civilian imports more easily than Tehran. Iraq's heavy borrowing caused its non-Arab military and civilian debt to rise from about \$5 billion in 1979 to \$40 billion in 1987. Baghdad's success at rescheduling its debt allowed it to postpone large repayments while continuing to fund its war effort.

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In addition, Iraq received \$35 billion in interest-free “soft” loans since 1980 from its Arab allies in the Persian Gulf, mainly Saudi Arabia and Kuwait. This assistance has been in the form of crude oil sales from the Neutral Zone on Iraq's behalf and cash payments. The level of aid decreased in recent years as oil earnings fell, but Saudi Arabia and Kuwait, fearful that an Iranian victory would jeopardize their security, continued to provide sizable assistance.

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Iraq also drew down foreign exchange reserves and slashed civilian imports. Its foreign assets—including foreign exchange reserves and gold—fell from \$36 billion in 1980 to about \$3 billion in 1987. After pursuing economic development and increasing civilian imports during the early years of the war, Iraq adopted austerity policies in 1982. In 1987, Iraq's civilian imports amounted to \$7.1 billion—roughly half the level in 1980. Baghdad restricted its civilian imports to essential goods like food and medicine

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Table 1
How Do Iran-Iraq Economies
Compare? ^a

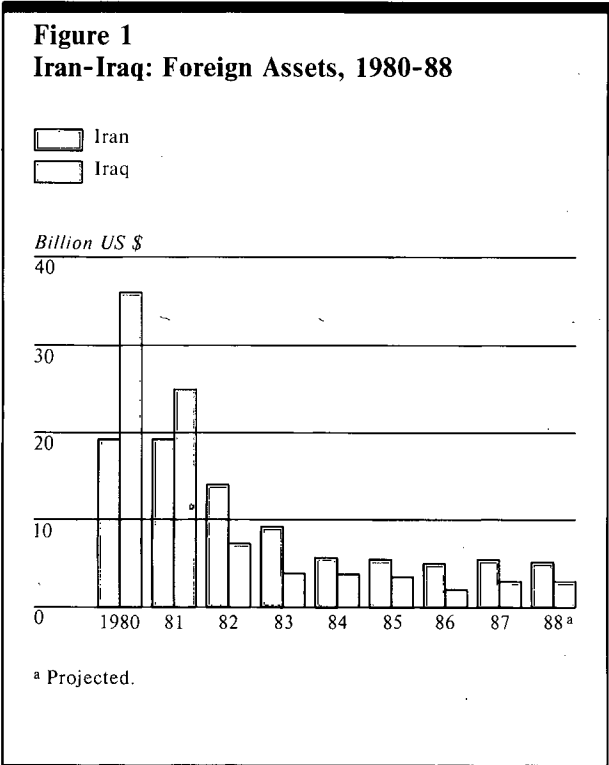
	Iran	Iraq		Iran	Iraq
Demographics			Current annual inflation rate	30 to 40 percent	About 30 percent
Population ^b	52.0 million	17.6 million	Unemployment rate	About 30 percent	Less than 5 percent
Male	26.5 million	9.0 million	Trade and finance		
Female	25.5 million	8.6 million	Primary civilian trading partners		
Growth rate ^b	3.2 percent	3.5 percent	Exports	West Germany, Japan, Turkey, Italy, United Kingdom	Turkey, Yugoslavia, Brazil, Italy, France
Doubling time	22 years	20 years	Imports	West Germany, Japan, Turkey, Italy, United Kingdom	Turkey, United States, West Germany, United Kingdom, Japan, France
Population younger than 15	45.5 percent	45.0 percent	Exports		
Population in urban areas	51.0 percent	70.0 percent	Oil	\$11 billion	\$11 billion
Religion			Nonoil	\$1 billion (mostly pistachios, carpets, textiles)	\$0.6 billion (mostly petroleum products, manufactured goods, sulfur)
Shia Muslim	94 percent	63 percent	Foreign debt	\$5.5 billion	\$40 billion
Sunni Muslim	5 percent	34 percent	Foreign assets	\$5.5 billion	\$3 billion
Other	1 percent	3 percent	Estimated current account deficit	About \$2 billion	About \$3 billion
Life expectancy ^b					
Life expectancy ^b	57 years	64 years			
Literacy ^b					
Literacy ^b	48 percent	55 percent			
Economy					
Natural resources	Oil, natural gas, copper, iron ore, coal	Oil, natural gas, phosphates, sulfur			
Agriculture	Wheat, barley, rice, pistachios, caviar, cotton	Dates, wheat, rice, livestock			
Major industries	Crude oil production and refining, textiles, food processing, metalworks	Crude oil production and refining, light industry			
Estimated per capita gross domestic product	\$1,800	\$2,000			

^a 1987 data.

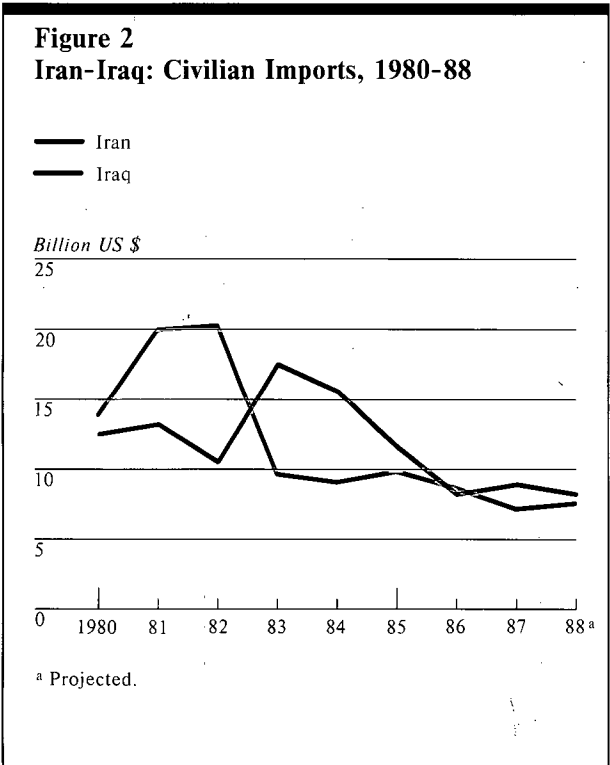
^b Midyear 1988 data.

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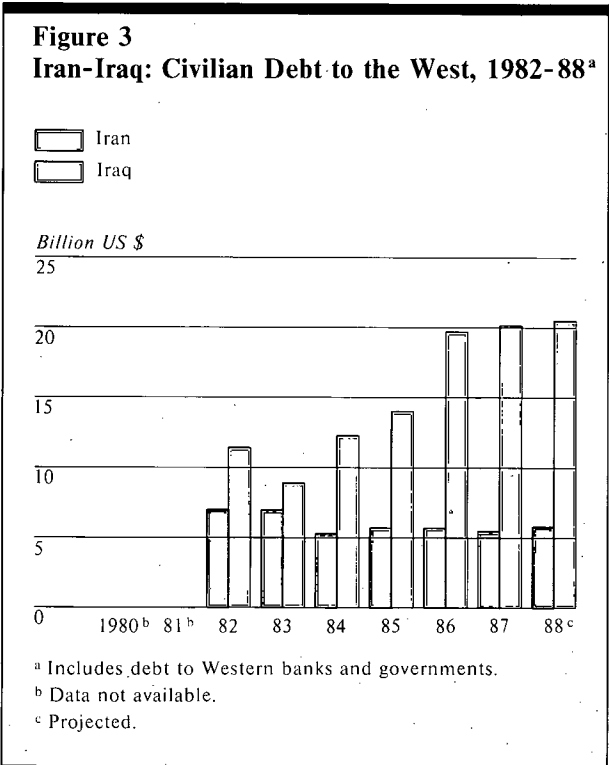


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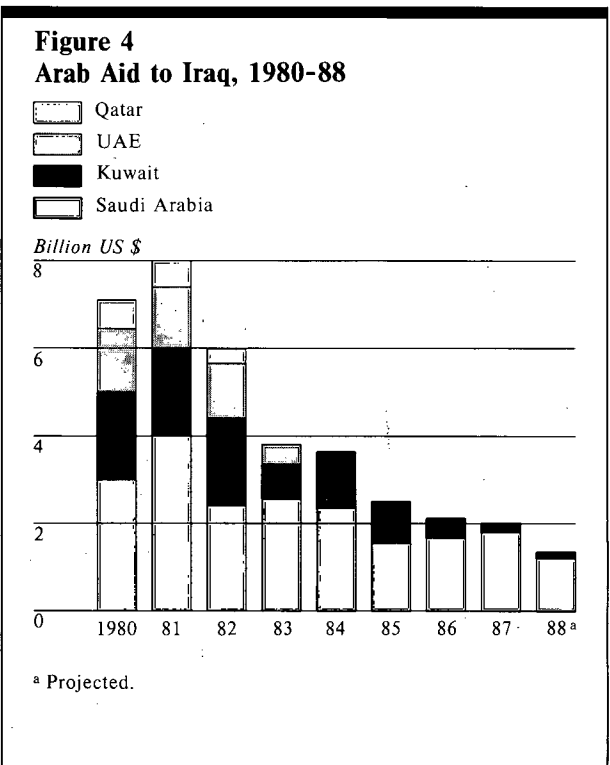


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Inflation, Shortages, and Unemployment: How Have Iranians Gotten By?

A national rationing program, open and black markets, the government's martyrs' and unemployment benefits, private charitable support, and ingenuity combined to help Iranians make ends meet during the war. The Khomeini regime instituted rationing shortly after the conflict began. The government issued each family a set of coupons redeemable at designated outlets for food and other basic necessities at well below market prices. Doctors publicly complained that official quantities did not provide adequate nutrition

but Tehran claimed that rationing was supplementary and was never intended to supply a complete diet.

Iran's extensive open market offered an alternative source to supplemental rations. Food prices here ranged as high as 10 times the ration prices. Large profits available to sellers in these markets frequently caused the diversion of goods originally intended for ration outlets.

Tehran has paid significant martyrs' benefits to the families of war dead and has made unemployment benefits available to some Iranians. A martyr's wife could obtain the equivalent of a \$30,000 lump sum payment—roughly two years' worth of salary for an

Iranian engineer—plus \$575 a month. apparently for life, [] If a martyr left behind a large family, additional benefits such as durable goods have been provided. In August 1987, Iran's Ministry of Labor established unemployment insurance entitling some laid-off employees to monthly unemployment payments of up to \$575

This wide variety of assistance provided a buffer to economic austerity for many Iranians.

There have been numerous private sources of support for Iranians as well. Small community banks associated with mosques—called "Funds for the Lending of Money for Good Purposes"—sprang up throughout the country

These banks have offered loans of up to \$30,000 with a minimum of redtape.

Many Iranians tapped savings and entered Iran's open- and black-market systems as brokers of scarce and illegally imported goods.

press accounts indicate many of Iran's unemployed workers have become part of the service sector generated by Tehran's austerity measures—brokering goods ranging from cigarettes to Mercedes-Benz automobiles.

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as well as materials needed to keep its vital defense and oil industries operating. Iraq also reduced government subsidies to conserve revenues.

Which Economy Is More Dependent on Oil?

Both Iran and Iraq are critically dependent on oil as a hard currency earner and as a large contributor to their national output. Disruptions in their oil sectors—whether in production or by a fall in world oil prices—cause major economic problems.

Iran's oil sector has significantly declined as a share of Iranian gross national product in recent years,

reflecting a fall in oil export revenues. Although the oil sector has shrunk from at least 38 percent of gross national product at the beginning of the Iranian revolution to less than 10 percent in 1987, Iran's nonoil gross national product in real terms has also fallen because of the revolution and the war. Iran's agricultural and services sectors have made gains, but Iran's response to lower oil revenues—slashing raw materials and machinery imports—has depressed the nonoil industrial sector.

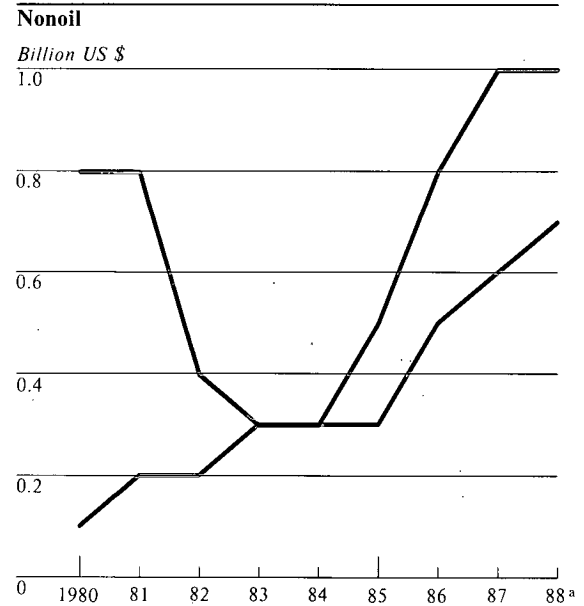
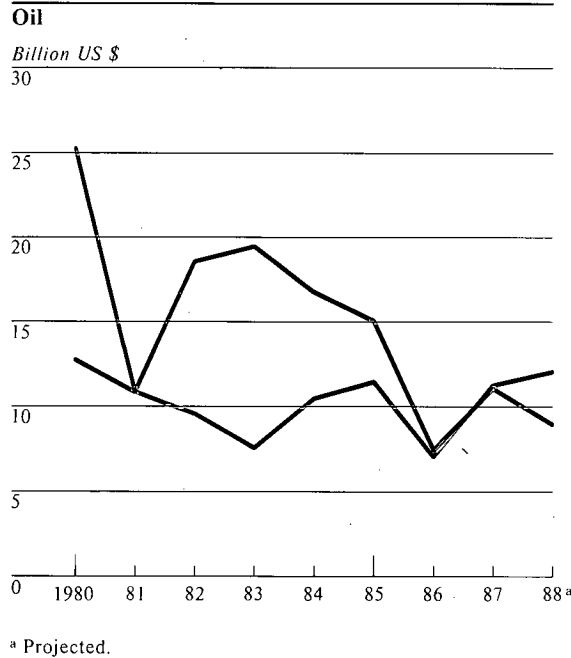
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Figure 5
Iran-Iraq: Oil and Nonoil Export Revenues, 1980-88

— Iran
— Iraq



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Iranian nonoil exports—mostly carpets, textiles, and pistachios—have almost doubled as a share of total exports since 1985, but crude oil sales still account for at least 90 percent of Iran's hard currency earnings. Foreign sales of nonoil goods have earned almost a billion dollars annually in recent years, but the fall in oil revenues—rather than higher nonoil output—is largely responsible for the increase in the share of nonoil exports. Recent increases in Iran's nonoil exports have been insufficient to offset the fall in oil revenues.

Iraq's oil export revenues account for about 95 percent of export earnings, although the value of its nonoil exports—petroleum products, manufactured goods, sulphur, and food—has steadily increased in

the 1980s. Oil production accounted for roughly 40 percent of Iraq's gross national product in 1987, as compared with about 50 percent in 1979-80. The decline in share primarily reflects reduced oil production and lower oil prices instead of real gains in nonoil sectors.

Which Country's Oil Infrastructure Is in Better Condition?

Iraq's oil infrastructure is in better condition than Iran's because it sustained less war damage and has been better maintained.² Baghdad has placed high

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priority on rebuilding its oil sector, especially its oil export capability. The closing of Iraq's Gulf terminals in 1980 and Syria's closing of the Iraq-Syria pipeline in 1982 slashed oil exports to less than 1 million barrels per day (b/d). Iraq increased the capacity of the pipeline through Turkey from about 700,000 b/d to 1 million b/d in 1984 and expanded the line to 1.5 million b/d in 1987. Baghdad began exporting oil through the 500,000 b/d pipeline link to Saudi Arabia's Petrolina to its Red Sea port at Yanbu' al Bahr in 1985 and began constructing phase two of the Iraqi-Saudi pipeline last year. This expansion will increase the line's capacity to 1.6 million b/d and will enable Iraq to export near prewar levels of 3.5 million b/d. []

Iraq has also increased its refining capacity above its prewar level, despite the mothballing of its largest refinery at Al Basrah and the temporary closing of two other plants because of war damage. The expansion was achieved by installing several topping units and by inaugurating two stages of a major new refinery at Bayji. Iraq has refined more products than it needs domestically and has exported the rest. []

In contrast, Iran has allowed its oil sector to deteriorate despite the important role that oil plays in its economy. Early in the revolution, the Khomeini regime pressed for a reduction in Iranian oil production to conserve "Allah's bounty" for future generations. In the early years of the war, high oil prices allowed Iran to earn large revenues without expanding or even maintaining production and export volumes. []

[] As the war progressed, however, the cost of repairing Iraqi-inflicted damage to oil facilities began to accumulate while oil revenues fell. []

Tehran's neglect has resulted in a large reduction of its oil production capacity from the roughly 6 million b/d reached under the Shah. []

Inflation and Shortages: How Have Iraqis Gotten By?

The Iraqi Government instituted several plans during the war to protect its populace from economic hardships caused by wartime austerity measures. It used price controls and price subsidies to control prices of essential goods. Iraq did not implement a national rationing program but established other means of regulating limited consumer supplies and preventing hoarding. Many local People's Councils issued cards to residents allowing them to buy limited amounts of scarce goods at local shops. These groups monitored deliveries to, and sales by, shops to prevent shopkeepers from hoarding goods to push up prices or from selling to favored customers. The government also established various "specialized agencies" that regulated sales of goods in limited supply. []

The Iraqi Government has also provided consumer subsidies and gifts to war martyrs' families, military officers, and other favored groups, although these benefits were significantly pared back after 1985 when foreign exchange revenues plummeted. Since then, martyrs' families have received government land, soft loans, pensions, and preferential admission to universities, according to the US Embassy in Baghdad. []

Iraqi consumers have utilized a thriving black market to acquire goods unavailable in the open economy because of import restrictions and domestic spending cutbacks. Black-market prices usually have been about two to three times as high as regulated prices. []

The majority of Iraqis have dealt in the black market through intermediaries to avoid severe legal penalties, including execution. []

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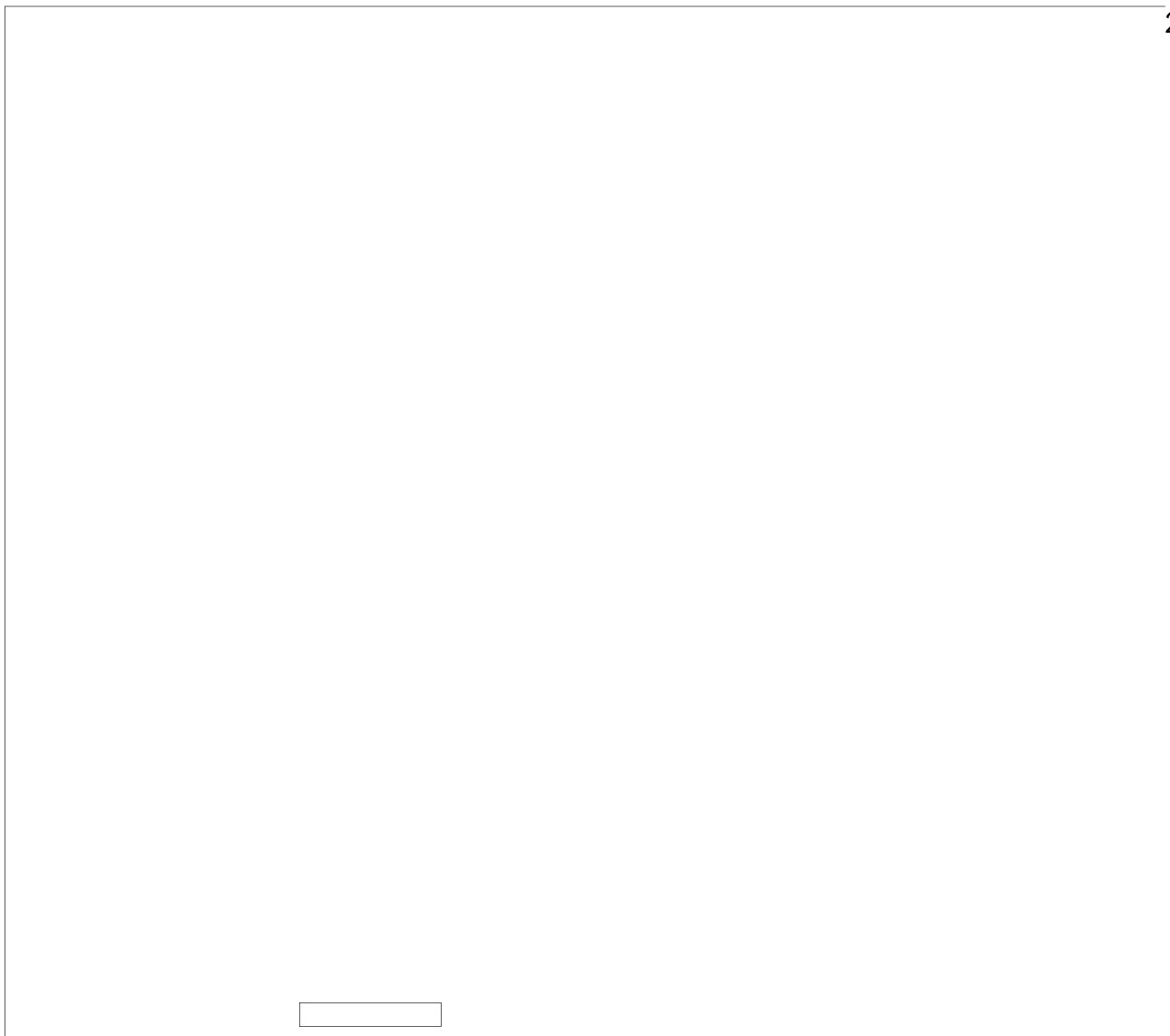
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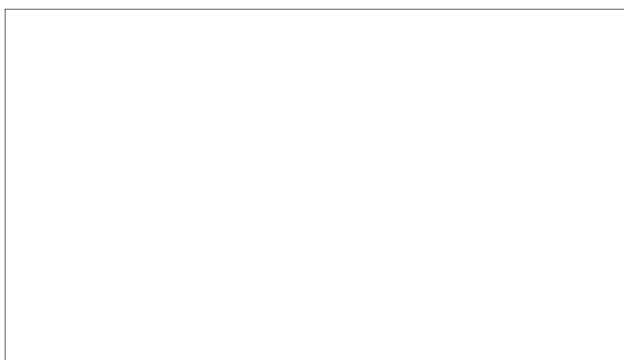
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Iran's oil refining capacity has seriously declined, largely because of war damage. Iraq destroyed Iran's 500,000 b/d refinery at Abadan early in the war. Additional strikes against the remaining refineries have forced Iran to import roughly 200,000 b/d of refined products, [redacted] Iran has designed plans to restore its refining capacity, but, like other projects, funding problems have delayed implementation. [redacted]

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**Which Economy Could Better Cope
With an Oil Price Collapse?**

Iraq could cope better with an oil price collapse than Iran because its oil export capacity is increasing, and we believe it has greater room to reduce civilian spending. Iraq has higher oil export capacity than it did in 1986 when spot prices dipped below \$9 per barrel—1.8 million barrels per day (b/d) in 1986, as compared with 2.3 million b/d in mid-1988. Iraqi export capacity is expected to rise by another 1.1 million b/d in early 1990 when the IPSA-2 pipeline through Saudi Arabia is scheduled to be completed.

[]

Iraq's options to cope with a drop in oil receipts include tightening civilian imports, slashing development projects that require foreign exchange, and seeking debt relief from its creditors. Despite deep cuts in imports since 1982, we believe that Iraq can reduce foreign purchases further without forgoing essential goods. Such cutbacks would carry political risks, particularly because popular expectations are likely to be high in the postwar environment. Baghdad would be less likely to cut military imports significantly, especially while it perceives a continued Iranian military threat.

[]

Iran probably would respond to a major oil price decline by greatly expanding current austerity measures. This would include spending cuts that would risk further depressing popular morale. Tehran might seek long-term trade credits from foreign suppliers and delay paying current obligations. Tehran probably would compromise its policy of avoiding foreign borrowing if a major oil price slump lasted for more than six months but would strive to keep foreign loan negotiations secret.

[]

**Which Country's Nonoil Infrastructure
Is in Better Condition?**

Iraq's nonoil infrastructure is in better condition than Iran's because it sustained less war damage and because Baghdad has placed higher priority on maintenance and development than has Iran. Still, war damage to plants in Al Basrah, reduced maintenance of the existing capital stock, and the lack of new investment have hindered nonoil industries. Only war-related industries, industries manufacturing import substitutes, and plants producing building materials have received adequate maintenance.

[]

Baghdad has pursued several key infrastructure projects, despite massive cuts in development spending. By 1986, Iraq's installed electrical capacity exceeded its prewar level. It has sought to build redundancy into its electrical supply network after Iranian air-strikes caused power outages early in the war. Construction of several new thermal and hydroelectric power plants continues. Baghdad has pursued various water projects, largely to help secure scarce water supplies in the region. The inauguration of the Haditha Dam on the Euphrates River and the completion of stage one of the Mosul Dam on the Tigris River in 1984 have improved irrigation. The massive Bekme Dam is expected to be completed in the early 1990s.

[]

Iraq's transportation facilities have improved partly in response to war needs. The closure of Iraq's ports and the Shatt al Arab waterway as a result of the war increased the need for overland transportation routes. Between 1980 and 1986 about 2,100 kilometers of new highways were completed. Several other major roads remain only partially completed, however, because of lack of financing, labor, and building materials. Iraq is one of the few Middle Eastern countries that has pursued new railway construction. Since the start of the war, the Iraqis have added a 520-kilometer line between Baghdad, Al Qa'im, and Akashat and a 250-kilometer section of railway between Al Hadithah and Karkuk.

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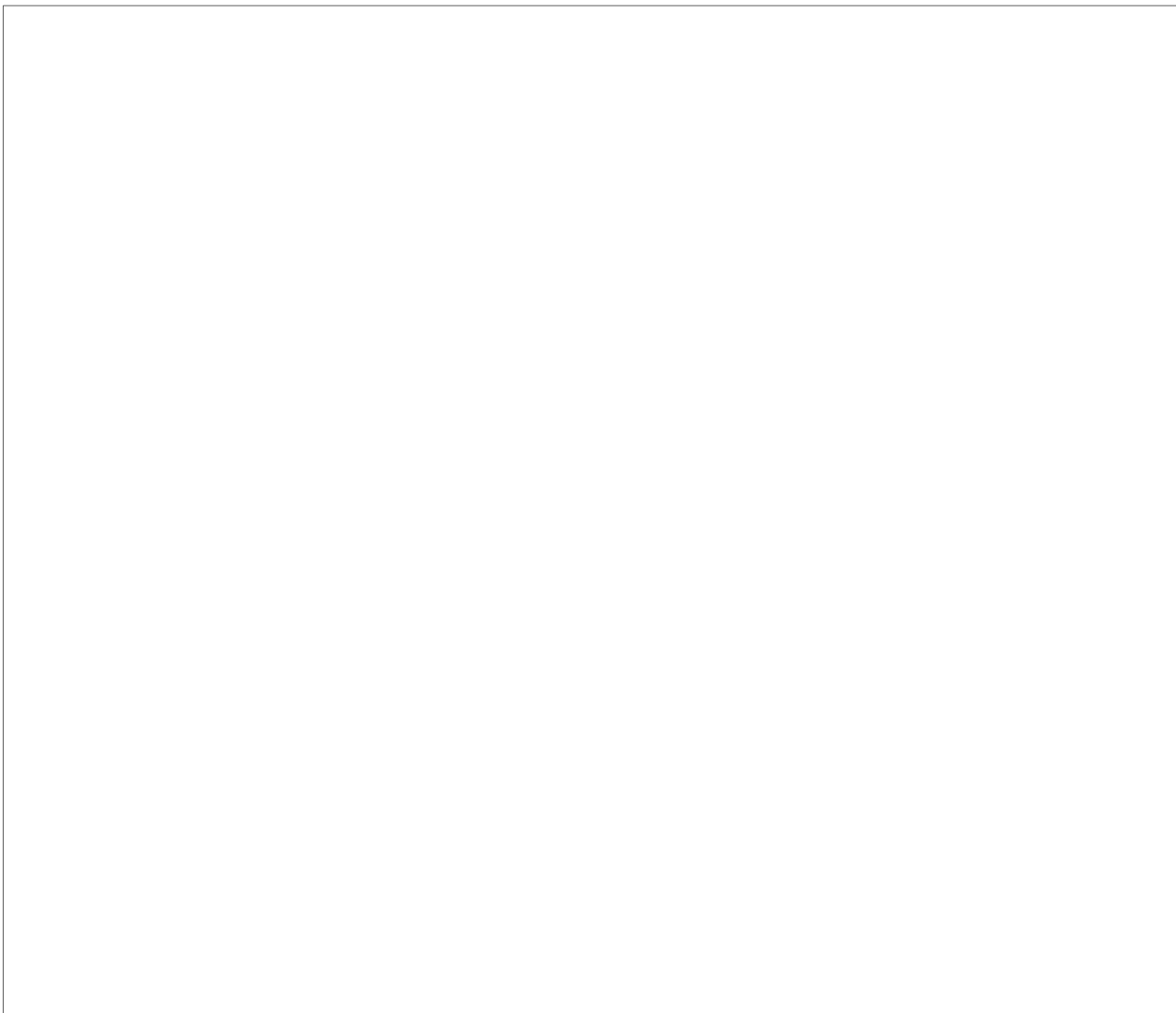
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Iraq has continued to expand its telecommunications network. Between 1980 and 1986 it more than doubled its number of phone lines to 1 million. Installation of a microwave network has improved rural and international phone service, and the launching of the Arabsat satellite in 1985 improved Iraq's communication with other Arab countries. [redacted]

country of Iran's size should have an electricity generation capacity of 25,000 megawatts to adequately supply private and industrial consumers with power, yet Iran's actual generating capacity is less than one-third this amount. [redacted]

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In contrast, *Iran's* neglect of its civilian economy to free up resources for the war has caused widespread erosion throughout its infrastructure, including such primary sectors as power generation and transportation. [redacted] a

Although daily power

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outages are common, Iran has delayed plans to increase power generation because of funding shortages. Its power generation problems are particularly ominous considering that they would be far worse if Iranian industry were operating at normal levels.

The regime has maintained some important highways, but secondary feeder roads are in such bad shape that farmers in some provinces have offered to help pay for repairs, Population growth in Tehran has seriously outpaced the city's transit system, and insufficient funding has delayed construction of a long-planned Tehran metrorail system.

Although Tehran has not completely halted development spending, the few schemes that have progressed have done so at a snail's pace. Some small dams have been built, and telecommunications, road, and rail schemes have been pursued.

Which Country Faces More Serious Social and Demographic Pressures?

Iran faces more serious overall growth problems than does Iraq because of its much larger population and poorly maintained economic infrastructure. Its population growth rate has averaged at least 3.5 percent annually in recent years, according to Iranian and Western demographers. Such growth has swelled its population from 37.5 million, when the Shah fell, to about 52 million by midyear 1988. We believe that, in roughly 20 years, Iran will be one of about 15 countries with populations of at least 100 million at its current population growth rate.

Iran's demographic problems have been worsened by its decision to pursue the war at the expense of the civilian economy. Expenditures to maintain its economic infrastructure have not kept pace with the enormous growth in demand for services and jobs caused by Iran's swelling population. This is particularly true in the cities, where immigration from rural

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areas has occurred in addition to the high natural growth. These two factors have roughly doubled the Tehran area's population—to about 10 million—since the revolution. []

Iran's health care system has seriously declined since the revolution. [] as of 1985, Iran had lost at least half of the 15,000 doctors it had under the Shah. Many of these physicians were educated in the West and left Iran rather than live under the Islamic regime. Others retired early to avoid service near the war front. Iran also suffers from a critical shortage of nurses []

[] A large number of university-trained nurses left Iran's hospitals shortly after the revolution, and many of those who remained have been relegated to nonnursing jobs or to all-female wards because of an Islamic regulation that forbids women from treating men. Cuts in civilian imports have led to serious shortages of medicines, pharmaceuticals, and medical equipment and replacement parts. []

In contrast, rapid population growth in *Iraq*—also about 3.5 percent—will have a positive effect by muting the long-term structural effect of war casualties on *Iraq*'s labor-short economy. *Iraq*'s population has grown from about 13 million before the war to about 18 million in 1987. The *Iraqi* regime has offered monetary and other incentives to encourage a high birthrate and to help ensure manpower for future economic development projects and national defense. *Iraq*'s high fertility rate—nearly 7 percent—and youthful population indicate a continued high rate of population growth. []

Urban population growth has been particularly high because of the concentration of economic activity in major cities, greater availability of social services, and higher wages. The most rapid growth has occurred in and around Baghdad and Al Basrah. Iranian bombing and shelling of Al Basrah in 1986-87 precipitated a large exodus, but this began to reverse with the advent of the cease-fire. Rapid urban growth has pushed up rents in major cities and has increased inflationary pressures on food prices, especially in Baghdad. []

The *Iraqi* regime's high priority on health care has markedly improved the availability of health services, although they remain inadequate in rural areas and the war created a shortage of civilian doctors. The number of hospitals, hospital beds, and doctors have increased, average life expectancy has increased, and the infant mortality rate has dropped. Despite these trends, government efforts have barely kept up with the growing demands for medical attention. []

The war has aggravated serious labor shortages in *Iraq* despite the country's rapid population growth. *Iraq* has alleviated labor shortages by importing labor—at least 1 million foreigners were working in *Iraq* in 1987—encouraging participation by women, and improving worker skills. Labor shortages have been particularly prevalent in the agricultural sector as many workers have joined the military or moved to cities. []

Which Country Has Closer Economic Ties to the West?

Iran has closer economic ties to the West than *Iraq*, although both countries depend heavily on OECD countries as suppliers of civilian imports and as export markets. Although Iranian trade with the West has declined since the revolution, Tehran still relied on the OECD for about 70 percent of its nonmilitary imports in 1987, worth about \$6.1 billion. West Germany and Japan are by far *Iran*'s two largest suppliers, each selling at least \$1 billion worth of goods to *Iran* last year. Bonn and Tokyo supply mostly manufactured items, including vehicles and replacement parts. Italy, France, Japan, the United Kingdom, and Switzerland supply oil equipment and spare parts that are essential to *Iran*'s oil industry. []

Tehran restricts US imports, but a strong Iranian appetite for US technology persists. US exports to *Iran* in 1987 totaled just \$60 million—compared with \$4 billion in 1978 []

[redacted] Most Iranian purchases of US goods or services are handled through non-US trading firms or foreign subsidiaries of US companies. [redacted]

Despite an interest in OECD expertise, Iran's financial limitations have often made quality a lesser consideration than price. Because their labor costs are generally lower, South Korean and East European firms frequently receive construction and engineering contracts instead of their OECD competitors. Willingness of suppliers to provide financing or to accept oil as payment has become an important Iranian consideration. [redacted]

Iran's largest export markets are in the West. It exported \$7.1 billion worth of goods—mostly oil—to the OECD in 1987, equivalent to roughly 60 percent of its sales abroad. Iran's exports to the United States and Japan alone represented at least 35 percent of this total. Trade statistics indicate the United States imported more goods from Iran in 1987—\$1.6 billion—than any other country, despite the US trade embargo against Iranian goods in late 1987. Since then, Iranian exports to the United States have come to a halt, but Japan, Italy, France, West Germany, and the United Kingdom continue to be major Western customers. [redacted]

Outside of trade, Iran has relatively few economic ties to the West. Its external debt—mostly short-term trade credits from Western banks—is only about \$5.5 billion. Iranian investments in the West are limited primarily to foreign exchange holdings and gold, [redacted]

Iraq is heavily dependent on Western civilian imports, although the value of its purchases—about \$3.8 billion in 1987—is smaller than Iran's. During the 1980s, Iraq has purchased an average of 70 percent of its civilian imports from OECD countries, mostly the

Table 2
Iraq: Financing Sources and Requirements, 1988 ^a

	Billion US \$
Financing sources	14.1
Oil export revenues	12.0
Nonoil export revenues	0.7
Arab aid	1.4
Financial requirements	19.8
Military imports	5.0
Civilian imports	7.5
Invisibles	1.3
Principal payments on foreign debt	4.3
Interest payments on foreign debt	1.7
Financing gap	-5.7

^a Projected.

[redacted] United States, Japan, the United Kingdom, West Germany, France, and Italy. At least three-quarters of these purchases were machinery and capital equipment—most of which are unavailable from other sources—and the rest were largely agricultural goods. Iraq generally favors Western technicians in development projects involving advanced technology because of their superior skills. [redacted]

Western sales of goods and services to Iraq have suffered since 1982 because of austerity measures. Baghdad has been forced to reduce civilian imports from all sources and to substitute less expensive goods available from developing countries for those normally purchased from the West. Because Baghdad has also lent more weight to financing terms than to technical capability in awarding many contracts, Western firms have lost business to those in the Third World and in the Soviet Bloc that have been more willing to provide financing. [redacted]

Iraq has recently sought to expand economic ties to several Western countries, including the United States. Press, [] reporting indicate that Iraqi officials are encouraging Western firms to bid for more contracts in Iraq, including those in the oil sector. This is an important switch because major Western oil firms have been largely limited to providing technical support since Baghdad completed nationalization of its oil industry in 1975. Last fall Iraq awarded the contract for the priority construction of the IPSA-2 pipeline to a Western consortium. Iraq is interested in expanding US commercial ties—which currently focus on agricultural sales—in several areas, according to the US Embassy in Baghdad, including oilfield development and agricultural projects in which the USSR traditionally has been involved.

Military deliveries to Iraq by Western countries have been limited because of Baghdad's close military supply relationship with the USSR. The West's share of military deliveries to Iraq—mostly by France—peaked at 35 percent in 1983 but has declined since then. Paris has been willing to supply equipment—mostly aircraft, radars, spare parts, and munitions—on credit, which has facilitated this relationship.

Iraq relies heavily on the West as an export market. It delivers about 55 percent of its exports—mostly oil—to the OECD. Its main customers are Japan, Italy, and West Germany. []

By yearend 1987, Iraq had accumulated nearly \$30 billion in debt to Western governments, commercial banks, and private firms for trade and project financing. Iraqi investments in the West are limited and consist mostly of foreign exchange holdings in Western banks. []

Which Economy Offers Greater Economic Opportunities for the United States?

Both Iran and Iraq offer significant commercial opportunities for the United States—especially during the reconstruction stage—but these opportunities are likely to be greater in Iraq than in Iran in the short term. Expected higher oil revenues will help Iraq to proceed with reconstruction and development of its oil sector and infrastructure, increasing the potential market for US products and services. Press, [] reporting indicate Iraq will be a strong market for oilfield development technology, capital equipment, computers, agricultural machinery, electrical distribution and transmission equipment, and medical equipment. In addition, Iraq almost certainly will boost postwar imports of nonfood consumer goods and will continue to import food. []

[] Iraq wants to promote stronger economic ties to the United States in hopes that they will help offset what Baghdad regards as Iran's greater geopolitical importance to Washington. Moreover, the Iraqis highly value US technology for military and commercial applications. []

The larger size of *Iran's* economy and the fact that it is in great need of repair present large commercial opportunities for US companies, but these opportunities will be greatly limited unless political relations improve and Iran receives large-scale financial assistance. Tehran has restricted US imports since the revolution, although it remains interested in US technology. Iran will need billions of dollars in foreign goods and services to rebuild and develop its economy. Its oil industry alone will require tens of billions of dollars to stem the erosion it has suffered since the revolution. In addition, Iran's rapidly growing population represents a large potential market for basic commodities. []

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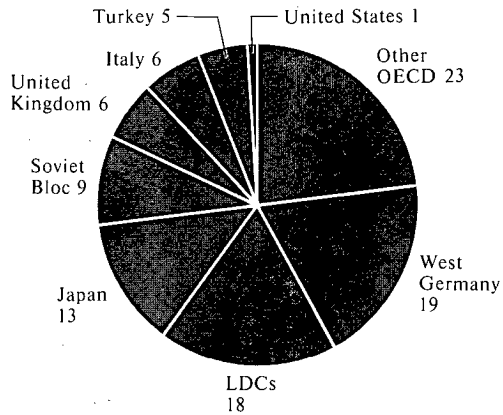
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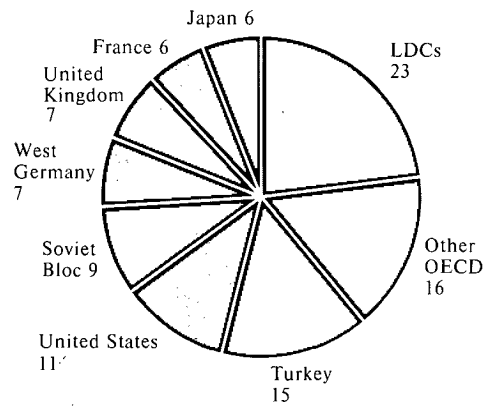
Figure 9
Iran-Iraq: Sources of Civilian Imports, 1987

Percent

Iran



Iraq



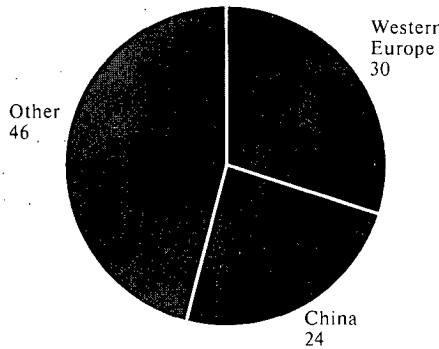
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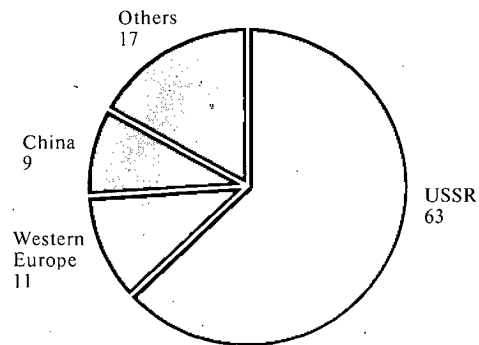
Figure 10
Iran-Iraq: Sources of Military Imports, 1985-87

Percent

Iran



Iraq

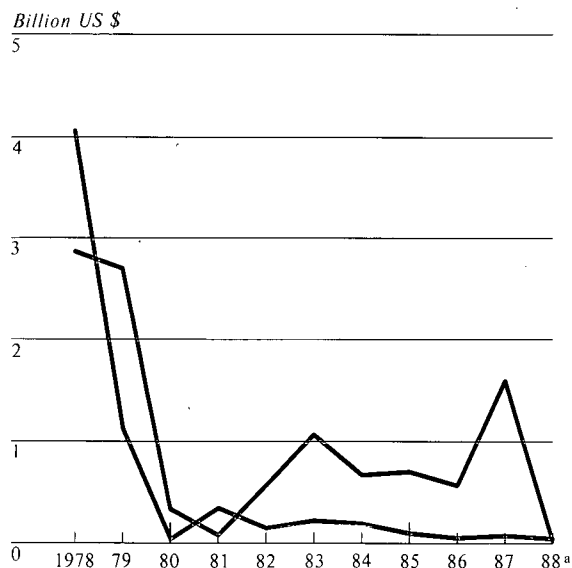


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Figure 11
Iran: Trade With the United States, 1978-88

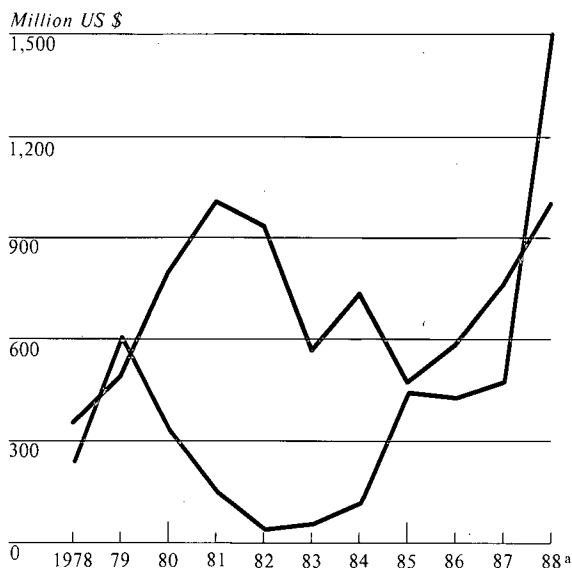
— Exports
— Imports

^a Projected.

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Figure 12
Iraq: Trade With the United States, 1978-88

— Exports
— Imports

^a Projected.

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Iran's financial problems are likely to limit commercial opportunities for most foreign firms. A large reconstruction fund would increase commercial opportunities in Iran, including those for US firms, especially if the United States contributed to such a fund. Tehran's preferred method of financing after cash grants most likely will be to pay foreign suppliers with oil. Tehran almost certainly will soften its opposition to foreign credit, but political factors will probably prevent it from seeking large, multibillion-dollar cash loans in the near term. Most Iranian leaders are reluctant to abandon the revolution's commitment to financial independence despite the call by moderates for foreign assistance. Furthermore, many lenders are unwilling to extend large loans to

Tehran because of concern about Iran's political stability. Iran will probably receive some financing tied to specific projects [redacted]

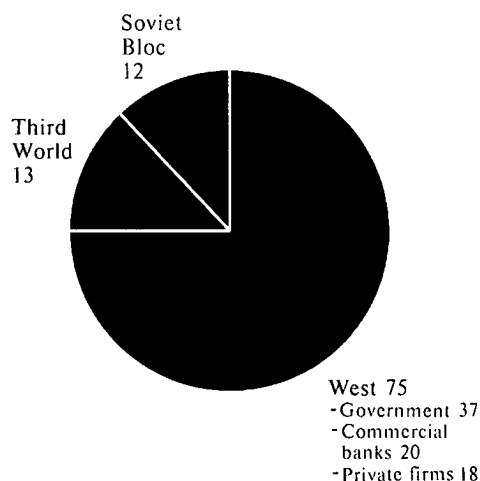
Which Country Has Closer Economic Ties to the Soviet Bloc?

Iraq has closer economic ties to the Soviet Bloc than has Iran because of Baghdad's close military supply relationship with the USSR and its allies, as well as Bloc participation in several important development projects in Iraq. We estimate that about 25 percent of Iraq's total trade last year was with the Bloc. Bloc

Figure 13
Iraq: Foreign Military and Civilian Debt
by Source, Yearend 1987^a

Total \$40 billion

Percent



^a Excludes \$35 billion in soft debt owed to Gulf Arab countries.

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countries have supplied 60 percent of Baghdad's arms purchases since 1979 and delivered about 80 percent in 1987. The USSR, which delivered 63 percent of Iraq's arms last year, supplied most of this share. Baghdad has found Soviet military equipment attractive because it is relatively inexpensive, rugged, available on short notice, and fits the Iraqi armed forces' tactical doctrine. The political alignment of Iraq and the Bloc has traditionally enhanced this relationship. We estimate Iraq's debt to the Bloc—mostly to the USSR for military purchases—was about \$7.5 billion at yearend 1987.

Soviet Bloc firms have played an important role in civilian development projects in Iraq. The USSR's provision of long-term, low-interest loans and many East Europeans' acceptance of oil as payment have placed them in a good position to win Iraqi contracts. In addition, many workers from Bloc firms were willing to continue working in Iraq despite the danger

from war. Bloc countries have been involved in a variety of projects, including oil exploration and development, irrigation and land reclamation, and construction of roads, power plants, and factories. In December 1987, the USSR claimed to be involved in nearly 100 projects in Iraq, according to the US Embassy in Baghdad, although we believe many of these schemes are on hold because of Iraq's financial constraints.

The Bloc has supplied about 10 percent of Iraq's civilian imports in the 1980s. In contrast to military sales, which the Soviets dominate, the East European countries—especially Romania and Bulgaria—have made about 90 percent of Bloc sales of civilian goods to Iraq. Bloc sales to Iraq have not been exempt from Iraqi import cuts and have fallen significantly since 1982. Still, the Bloc's share of total sales to Iraq has increased slightly, probably because these goods are less expensive and can be sometimes bartered for oil.

Iran's economic ties to the Soviet Bloc involve primarily civilian trade, and we estimate that no more than 10 percent of its military and civilian trade is with the Bloc. Iranian-Soviet economic relations have dropped precipitously since the 1970s because of economic and political factors. In the 1970s, Moscow imported some 10 billion cubic meters per year of Iranian natural gas, but price disputes virtually terminated these sales. The USSR withdrew almost all Soviet advisers from Iran, primarily because of concern for their safety during the war. Tehran's support for the Afghan rebels and its repressive measures against the Tudeh (Communist) Party and the Mujahedin-e Khalq—an anti-Khomeini Islamic Marxist group—have also hampered closer economic ties. Soviet arms deliveries to Iraq have also been a hindrance.

Iranian and Soviet officials met in 1987 to improve economic ties, but Iranian-Soviet trade—about \$200 million annually—remains small compared with Iran's Western trade. The two sides signed an agreement on joint oil exploration of the Caspian Sea

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[redacted] Much larger schemes such as a rail link from the USSR to the Persian Gulf and renewed Iranian gas exports—which would require construction of a new pipeline—have not progressed beyond the discussion stage. We estimate that financing for either of these schemes would cost at least \$1 billion—an amount that Iran cannot, and Moscow will not, provide. [redacted]

Iranian trade with Eastern Europe is small. It amounted to about \$1 billion in 1987, according to Iranian and East European trade data—about 5 percent of Iranian total trade. Tehran has pressed to increase this trade in recent years because many East Europeans are willing to accept oil as payment. [redacted]

What New Challenges Will Iran and Iraq Face in the Postwar Environment?

The largest postwar challenge both governments are likely to face will be allocating financial resources among new competing demands and meeting popular expectations for economic improvement. Without the war to divert public discontent away from economic deterioration, *Iran* will be pressed to provide new hope to a populace exhausted from supporting the conflict through many years of austerity. Tehran's inability to present a military victory to the Iranian population almost certainly will increase popular demands for economic improvements. [redacted]

Iranian leaders are likely to give increased attention to economic policy, and economic issues could become a source of major discord. This is especially true for issues such as land reform, government control of the economy, and the role of foreign business in Iran's reconstruction efforts. Disputes over economic policy could become highly divisive after Khomeini's death because his successors are likely to be less popular and less able to control factionalism. [redacted]

Deciding the proper role and size of the military will become a new problem for Iran when the war ends. Some Iranian leaders will want large reductions in military spending to free up resources for the civilian economy while others will press to maintain, and



Figure 14. New railroad lines under construction in Iraq. [redacted]

perhaps even increase, defense. In addition, Tehran will have to deal with the political risks of discharging several hundred thousand Iranian men who will return home to meager job prospects. [redacted]

Large postwar reconstruction payments could help Iran begin to mend its economy, but they could also lead to major political and economic tensions. Misguided spending could quickly fuel inflation and spark resentment among different interest groups that disagree on how the money is to be spent. The role of foreign business in reconstruction also could become a divisive political issue. [redacted]

Iraq, too, will have difficulty allocating its financial resources among several competing demands. We believe financial management will be more difficult for Iraq in a postwar environment than during the war because Baghdad can no longer use the war as an excuse for limiting expenditures. Although it will be less expensive than for Iran, reconstruction is certain to require a sizable share of Iraq's finances. [redacted]

Press, [redacted] reporting indicate that repairing damage to Iraq's oil sector and resuming oil exports through the Gulf are Baghdad's top priorities. [redacted]

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Figure 15. Al Basrah was heavily shelled by Iran during the war.



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Baghdad will face increased pressure from its creditors to meet its debt-servicing obligations on time. Most of Iraq's lenders have tolerated its repayment problems during the war and have rescheduled debt or provided new credits. Some creditors may take advantage of Baghdad's need for credits to fund reconstruction projects by promising new credits in return for larger debt repayments.

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Iraq's efforts to meet new financial demands will be complicated by its reluctance to reduce military spending significantly after the war ends. Postwar spending on imports of military equipment will probably remain near wartime levels of about \$5 billion annually because of continued distrust of Iranian intentions.

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The Iraqi Government is likely to face civilian pressure to redress import cutbacks in effect since 1982. To secure popular support for war-induced austerity measures, President Husayn's regime promised to boost civilian imports soon after the war ends. We believe the Iraqi urban populace, which is accustomed to a high living standard relative to many Middle Eastern countries, will not accept continued austerity measures but will expect Husayn to keep his promise.

Which Economy Has the Brighter Outlook?

We believe that *Iraq's* relatively successful efforts to maintain its economic infrastructure—especially its oil sector—make its economic outlook brighter than Iran's, particularly in the short term. Expected higher

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oil revenues—possibly \$15-20 billion annually by 1990—because of increased oil export capacity will allow Iraq to pay for imports, as well as reconstruction and other development projects, more comfortably and make greater payments on its debt. Baghdad will still look for foreign credit, however, especially to fund large projects. []

Over the longer term, Iraq's debt, if not managed carefully, probably would constrain growth. Baghdad is likely to continue to seek foreign credit, preventing it from paring down its \$40 billion debt soon. Iraq will probably not want to institute severe austerity measures to free up resources for its \$6 billion in principal and interest payments due each year for at least the next five years. Accordingly, Baghdad will probably need to reschedule several billion dollars annually, further increasing its future debt-service burden. Iraq will need to work with creditors to develop a more manageable repayment schedule, but, even with this, Baghdad faces multibillion-dollar debt payments for at least the next 10 years. Significant faltering in the oil market could cause Iraq's creditors to clamp down on new lending and make it increasingly difficult for Baghdad to secure new loans. During the longer term, we believe Iraq is in a better position than most other Third World countries to escape problem debtor status. Its potential oil wealth provides it with a viable means of earning foreign exchange—allowing it to reduce its current dependence on credit and to pay off its debt. In addition, President Saddam Husayn's pride and aversion to dependence on foreign countries may dissuade him from allowing Iraq's debt to rise sharply, and he is likely to try to reduce it eventually. []

The emplacement in 1987 of new economic leadership in Iraq and implementation of reforms to diminish the role of the state in Iraq's economy and expand private enterprise have increased the potential for efficiency and productivity in this socialist economy. Husayn has appointed a new breed of young, largely Western-educated technocrats to economic ministerial positions, replacing less qualified incumbents who at-

tained their positions mostly because of their Ba'th Party credentials. Press, [] reporting indicate Iraq's agricultural sector has been successfully privatized, and the Iraqi Government claims privatization is proceeding in other sectors. []

Iran's postrevolutionary neglect of its economy, its much larger population, and the likelihood of post-Khomeini political instability pose serious constraints to economic growth and improvements in living conditions. We estimate that the Iranian economy needs tens of billions of dollars of investment to return its per capita gross national product to levels achieved 10 years ago. It could easily take \$15-30 billion to begin reversing the erosion in Iran's oil industry that has occurred since the revolution. Although Tehran has shunned foreign financial assistance in the past, renewed interest in development will probably compel the regime to compromise this policy and seek limited foreign loans. []

Future gains in Iranian export earnings are likely to be quickly spent to meet the demands of Iran's large and rapidly growing population. Pressure on public services and housing are likely to become more severe, and widespread power outages will probably continue. Unless a major rebound in oil prices occurs, the most Iranians can hope for is that their slumping living standards remain near current levels. []

Iran's ability to marshal its economic resources is severely limited by factional disagreements over policy as conservative and radical factions paralyze decisionmaking. Radicals want broader state control of the economy and a major redistribution of wealth, including land reform, while conservatives favor a more market-oriented economy. Resolution of these difficulties is unlikely until the post-Khomeini succession is established. []

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